APPENDIX

THE TAX COURT OF THE UNITED STATES

OPINION

VAN FOSSAN, *Judge*: The sole question for our determination is whether the petitioner in each case at any time during its respective fiscal period here involved acquired an economic or depletable interest in the coal in dispute so as to entitle it to a percentage depletion allowance in accordance with sections 23 (m) and 114 (b) (4) (B) of the Internal Revenue Code.[1]

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[1] SEC. 23. DEDUCTIONS FROM GROSS INCOME.

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(m) Depletion.—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rates and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

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(b) Basis for Depletion.—

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(4) Percentage Depletion for Coal, Bauxite, Fluorspar, Flake Graphite, Vermiculite, Beryl, Feldspar, Mica, Talc (including Pyrophyllite), Lepidolite, Spodumene, Barite, Ball, Sagger, and China Clay, Rock Asphalt, Phosphate Rock, Trona, Bentonite, Gilsonite, Thenardite, and Metal Mines, Potash, and Sulfur.—

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(B) Definition of Gross Income From Property.—As used in this paragraph the term "gross income from the property" means the gross income from mining. The term "mining", as used herein, shall be considered to include not merely the extraction of the ores or minerals from the ground but also the ordinary treatment processes

The parties have stipulated that the Vincent referred to above in our findings of fact is one and the same person as the petitioner in *J. E. Vincent, et al.*, 19 T.C. 501; that petitioners herein are the same as to which reference was made in the findings of fact and opinion in such case; and that the contracts by and between Vincent and the petitioners herein are the same ones passed on there. Thus, we have heretofore considered the question here presented, i.e., whether Vincent, through his contracts with petitioners, transferred to them an economic interest in the coal. In holding there that such an interest did not pass to petitioners herein, we said that:

> * * * In Vincent's contracts with the Swaney companies, there were provisions for reduction or increase of the basic price per ton to be paid to the strippers if the current zone market of the price of coal was reduced below or increased above specified amounts per ton. They also contained a provision for cancelation by Vincent if the market price was reduced below a stated figure and if the parties failed to renegotiate the contracts. None of these provisions gave the stripping contractors an economic interest in the coal in

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normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products. The term "ordinary treatment processes", as used herein, shall include the following: (i) In the case of coal—cleaning, breaking, sizing, and loading for shipment; * * *

> place. The sliding price merely provided for adjustment of the price per ton to be paid to the strippers upon the coal that they mined and hauled. The Swaney companies were not dependent on the sale of coal by Vincent for their compensation, as both contracts provided that the failure of the sales agent to pay Vincent should not relieve Vincent of his obligation to pay the Swaneys the price agreed upon at the times and on the basis provided in the agreements. The contracts here were more like those involved in the *Morrisdale Coal Co.* case, * * * , than those in *James Ruston,* * * *.

Petitioners take the position that our ruling in the *Vincent* case is not binding here as to them inasmuch as they were not parties thereto, and that when all the evidence bearing upon the question is made available, as here, such evidence clearly points to the fact that petitioners' contracts with Vincent, as modified and construed by the parties, did give them an economic interest in the coal in place.

True, there is no place here for application of the doctrine of *res judicata,* but, after a thorough reconsideration of the question in light of all of the evidence appearing on this record, we remain unconvinced of any error in the ruling there made that no economic interest in the coal passed to petitioners during their respective fiscal years before us.

James Ruston, 19 T.C. 284, cited and relied upon by petitioners, is not, in our opinion, controlling here. It was also relied on in the *Vincent* case but was there held to be distinguishable. In their attempt to show that the factual situation here is parallel to and on all fours with that in the *Ruston* case, petitioners have introduced evidence bearing upon the distinguishing features between that case and the *Vincent* case, as pointed up in the *Vincent* opinion. Such evidence, however, falls short of establishing that the *Ruston* case is indistinguishable from the present cases.

On the record here made, we conclude and hold that petitioners did not, during their respective fiscal periods here under review, possess an economic interest in the coal in place, and that they are not entitled to the depletion allowances sought See *Morrisdale Coal Mining Co.,* 19 T.C. 208.

Accordingly, respondent's determination is sustained.

Decisions will be entered for the respondent.

Entered December 4, 1953.

Filed April 9, 1954

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 6727

COMMISSIONER OF INTERNAL REVENUE, PETITIONER AND CROSS-RESPONDENT

versus

GREGORY RUN COAL COMPANY, RESPONDENT AND CROSS-PETITIONER

No. 6728

COMMISSIONER OF INTERNAL REVENUE, PETITIONER AND CROSS-RESPONDENT

versus

J. E. VINCENT, RESPONDENT AND CROSS-PETITIONER

No. 6729

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

versus

J. E. VINCENT COMPANY, INC., RESPONDENT

No. 6730

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

versus

J. E. VINCENT COMPANY, INC., RESPONDENT

No. 6767

B. H. SWANEY & SONS, INC., AND SWANEY CONTRACTING COMPANY, PETITIONERS

versus

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITIONS TO REVIEW THE DECISIONS OF THE TAX COURT OF THE UNITED STATES

(Argued March 16, 1954. Decided April 9, 1954.)

Before PARKER, Chief Judge, and SOPER and DOBIE, Circuit Judges

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Sidney B. Gambill (James H. Beal, Robert F. Banks and Reed, Smith, Shaw & McClay on brief) for Gregory Run Coal Company, J. E. Vincent

and J. E. Vincent Company, Inc.; Robert B. Ross, Special Assistant to the Attorney General, (H. Brian Holland, Assistant Attorney General; Ellis N. Slack and Lee A. Jackson, Special Assistants to the Attorney General, on brief) for Commissioner of Internal Revenue; Arch M. Cantrall (W. G. Stathers and Stathers & Cantrall on brief) for B. H. Swaney & Sons., Inc., and Swaney Contracting Company; and Richard L. Levy, William T. Coleman, Jr., Edgar J. Goodrich, Lipman Redman, Dilworth, Paxson, Kalish & Green and Guggenheimer, Untermyer, Goodrich and Amram on brief for J. Robert Bazley, Inc. and John Schumacher *amici curiae.*

SOPER, Circuit Judge:

These appeals and cross appeals relate to the income taxes for 1947 of J. E. Vincent; the income taxes of J. E. Vincent Co., Inc. for the fiscal year ending April 30, 1948 and the fiscal year May 1, 1948 to January 3, 1949; the income, declared value excess profits, and excess profits taxes for the period June 11, 1945 to December 31, 1945 and income taxes for 1946 of Gregory Run Coal Company and the income taxes of B. H. Swaney & Sons, Inc. for the fiscal year ending September 30, 1947, and of Swaney Contracting Company for the fiscal year ended July 31, 1947. J. E. Vincent and the named corporations were engaged in the

business of strip mining of coal in Harrison County, West Virginia.

The most important question for determination is the disposition of the allowance for depletion, which in the case of coal mines is 5 per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect to the property. See Internal Revenue Code § 23(m), § 114(b)(4), § 29.23(m)-1 of Treasury Regulation 111.[2]

Other questions relate to (1) the right of the

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[2] Section 23(m) of the Internal Revenue Code provides that there shall be allowed as a deduction in computing net income in the case of mines, a reasonable allowance for depletion. Section 114(b) (4) of the Code enlarges on this by providing specifically that percentage depletion for coal mines shall be 5 per centum of the gross income from the property * * *, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer.

Section 29.23 (m)-1 of Treasury Regulations 111, promulgated under the Internal Revenue Code provides that the owner of an economic interest in mineral deposits is allowed annual depletion deductions, and defines 'economic interest' by stating that such an interest is possessed in every case in which the taxpayer has acquired, by investment, any interest in mineral in place and secures, by any form of legal relationship, income derived from the severance and sale of the mineral, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because, through a contractual relation to the owner, he possesses a mere economic advantage derived from production. Thus, an agreement between the owner of an economic interest and another entitling the latter to purchase the product upon production or to share in the net income derived from the interest of such owner does not convey a depletable economic interest.

Gregory Run Coal Company, one of the Vincent corporations, to deduct the amount of reserves set up by it in 1945 and 1946 to cover the cost of restoration work to be done thereafter; (2) the inclusion in the taxable income of Vincent for the year 1947 of the sum of $808,064.46 turned over by him to J. E. Vincent, Inc. in that year; and (3) the inclusion in the taxable income of J. E. Vincent, Inc. for the year 1947 of the sum of $53,795.64 paid by J. E. Vincent, Inc. to Gregory for coal purchased from Gregory and sold by J. E. Vincent, Inc.

In the spring of 1945 Vincent acquired four leases of coal lands which entitled him to strip mine coal on Gregory Run in Harrison County, West Virginia, at a specified royalty ranging from 10 to 12c per ton, payable in each case to the lessor. All of the leases obligated the lessee to comply with the laws of West Virginia which impose a duty on coal strippers to backfill and regrade the land stripped of coal and to plant trees and vegetation on it. W. Va. Code of 1949, Ch. 22, § 2461 (5).

On June 12, 1945 Vincent assigned these leases to the Gregory Run Coal Company, a West Virginia corporation, the stock of which was issued to him and J. B. Williamson in equal shares in consideration of the payment of $500 by each of them. Under the terms of the assignment Gregory was to pay Vincent the sum of $10,000 and a royalty of 40c per ton of the coal mined and sold. Under an arrangement between Vincent and Williamson

one-half of this royalty was to go to Vincent as part consideration for the assignment of the leases, and one-half to Williamson for the use by Gregory Run of a tipple owned by Williamson. These sums were held to be reasonable by the Tax Court. In order to carry on the operation Gregory Run purchased from Williamson strip mining equipment for the sum of $73,142.50 to be paid at the rate of 23.8c per ton of coal mined. Gregory also purchased additional equipment from Mrs. J. B. Williamson for $13,100 to be paid for at the rate of 6c per ton of coal mined.

At or about the same time Vincent entered into an agreement to sell to J. H. Weaver Company, a corporation, all of the strip coal that would be produced by Vincent from the leased premises and the Weaver Company agreed to pay the prevailing maximum sale price whether fixed by the Office of Price Administration or established by market conditions, less 25c a net ton, the price to be adjusted in case of a decrease in the market. Vincent was to pay all the rents and royalties due the lessors for the coal produced and sold. This agreement was assigned by Vincent to Gregory Run.

Also about the same time Vincent incorporated the Summit Fuel Company under the laws of West Virginia; and he and Williamson each acquired one-half of this stock. Gregory Run and Summit Fuel entered into a joint agreement for the mining of the leased property and the transportation and loading of the coal. Under the agreement this

was to be accomplished by the use of the tipple and strip-mining equipment belonging to Gregory Run, the use of motor vehicles belonging to Summit Fuel, and labor furnished by Summit Fuel. Summit Fuel was to mine and haul the coal to the tipple and process it and load it on the railroad cars and Gregory Run was to sell it. Summit Fuel also agreed to refill and recondition the surface of the mined area, in accordance with the laws of West Virginia; but Gregory Run was to obtain the permit required by the state law and bear the expense of the bond, and pay the cost of the refill.

Gregory Run filed its income tax returns on the accrual basis for the period from June 11, 1945, when it was incorporated, to the end of the year, and also for the year 1946. It claimed deductions in these years for reserves for back-filling in the respective amounts of $14,352.15 and $22,354.30, computed at the rate of 10c per ton mined. No backfilling has actually been done by or on behalf of Gregory Run.

On February 24, 1947 Gregory Run assigned the coal leases to Coal Service Corporation which agreed to substitute its bonds for those of Gregory Run so as to exonerate Gregory Run from liability thereunder and Gregory Run agreed to indemnify Coal Service against loss arising out of Gregory Run's operations on the leased premises, except with respect to claims of lessors based on the failure of Gregory Run to backfill and restore the property.

The Commissioner disallowed the deductions

claimed by Gregory Run for the estimated cost of backfilling. The Tax Court found for the Commissioner on this issue and Gregory Run has appealed.

Depletion Issue

The depletion issue is brought to this court by the appeal of the Commissioner in the cases of Gregory Run, No. 6727, Vincent, No. 6728, and Vincent, Inc., Nos. 6729 and 6730; and also by B. H. Swaney & Sons, Inc. and Swaney Contracting Company in case No. 6767. The question involved is whether the taxpayer, who mined the coal under the contracts herein described, as distinguished from the taxpayer, who held the leases on the coal land, had such an economic interest in the operation as to entitle it to take the deduction for depletion allowed by the federal statutes.

Gregory Run Depletion

Specifically the question in this regard is whether Gregory Run, in computing its depletion deduction for its tax years 1945 and 1946, was required to deduct from the gross income of its mining property the amounts it accrued and paid during these years to Summit Fuel, with the result that Summit Fuel could take a depletion deduction on its gross income. Summit Fuel, being controlled by Vincent, did not claim the deduction. This fact, however, did not affect the computation of the gross income of Gregory Run subject to the depletion deduction.

The contractual relationship between Gregory Run and Summit Fuel has already been described. In accordance with the agreement between them, Summit Fuel from June 11, 1945 to December 31, 1945 stripped and hauled coal from the leased properties and was paid by Gregory Run the sum of $222,617.43 therefor. In 1946 Summit stripped the land and hauled the coal until July 1, and thereafter Gregory Run did the stripping and Summit Fuel the hauling. During 1946 Gregory Run paid Summit Fuel $189,005.63 for stripping and $86,-367.19 for hauling; and these amounts were reported as income by Summit Fuel in 1945 and 1946. The Commissioner held that Gregory Run should exclude these amounts from its gross income in computing its depletion allowance. The Tax Court decided in favor of Gregory Run on this point and thereby denied Summit Fuel the right to share the deduction for depletion; and the Commissioner has appealed.[3]

Swaney's Depletion

A similar question arises with respect to the denial of a depletion deduction to B. H. Swaney

[3] The amounts paid by Gregory Run to Summit Fuel arose from the sale of the coal by Gregory and were paid in accordance with the contract between Gregory Run and Summit Fuel which provides that the latter "for its participation in this joint adventure" should receive $1.55 per ton for all the coal mined, transported and loaded by it. Either party had the right to cancel the agreement except that in case Gregory served notice of cancellation, then Summit should have the right to mine and remove all the coal which had been uncovered at that time.

& Sons, Inc. and Swaney Contracting Company in Case No. 6767. On December 24, 1945 Vincent entered into a contract with Swaney Contracting Company, a West Virginia corporation, wherein he employed the corporation to strip mine coal covered by the Dawson and other leases to Vincent on Lambert's Run. Under the contract Vincent provided the sidetrack and the tipple and the men to operate them, paid their wages, and had complete charge of the coal after it was loaded or dumped at the tipple. Swaney Contracting furnished the equipment and employees to mine and haul 25,000 tons of coal a month and bound itself to backfill and restore the land in accordance with the terms of the lease. Swaney Contracting agreed to secure the necessary bonds and mining permits required by the state, and to maintain adequate public liability and property damage insurance as to its operations. Vincent was to carry insurance as to the tipple and sidetrack. It was expressly provided that in all respects Swaney was to operate as an independent contractor in its field. Swaney Contracting was to be paid for its services on the basis of the coal accepted and paid for by the Weaver Company, the sales agent of Vincent, at the rate of $2.00 per net ton; but Vincent remained liable for the payment; and there were provisions for the adjustment of the basic payment in the event of a change in the sales price of the coal. The contract was not cancellable except on specified defaults by the parties or in the event that the sales price of the coal fell below $2.76

per ton. Vincent remained liable to pay the royalties due to the lessor under the leases.

Another stripping agreement was made on April 26, 1947 between Vincent and B. H. Swaney & Sons, Inc., another West Virginia corporation, with respect to property on Lambert's Run. Swaney, Inc. was to strip, load and haul to a tipple operated by Vincent all the coal under the lease that was not being operated by another contractor. The provisions of the agreement were similar to those in the contract between Vincent and Swaney Contracting, except that the compensation to Swaney, Inc. was to be at the rate of $2.18 per ton. Provision was made for adjustment on this compensation in the event of changes in the sales price of the coal. Vincent had the option to cancel the contract if the price of the coal fell to a point where the operations were unprofitable to him.

Both of the Swaney Companies carried out their agreements. The price of coal increased during the period of their operations. Each of them received compensation in excess of the base amount per ton specified in the contracts.

Vincent and J. E. Vincent Co., Inc., hereinafter referred to, both contended that there was no transfer of a depletable interest to either of the Swaney Companies under the contracts described above and hence Vincent or Vincent Company, Inc. was entitled to the statutory depletion deduction. The Tax Court sustained this contention in cases Nos.

6727 to 6730. Subsequently the Swaney cases were tried and the taxpayers contended that they were entitled to a depletion deduction but the Tax Court maintained the same position as it had in the Vincent cases, and the Swaney companies have appealed in case No. 6767.

Organization of J. E. Vincent Co., Inc.

On April 30, 1947 Vincent organized the J. E. Vincent Co., Inc. and there were issued to him 60 shares of stock, and to his wife and son 10 shares of stock each which were paid for at the rate of $100 per share. There is evidence that Vincent was in bad health and desired that his son, who had returned from military service, should have an interest in the business represented by the Lambert's Run property, and the corporation was formed for the purpose of taking over this business. The lessor, however, refused to permit Vincent to assign the lease to the new corporation. Thereupon on May 15, 1947 the directors of the corporation adopted a resolution that the corporation would operate the coal without a formal assignment of the leases just as if said assignment had been made; and on the same day the corporation entered into a contract with Vincent whereby Vincent leased to it the tipple, sidetrack and appurtenances, and gave it the right to load over the tipple the coal mined on the leased premises, in consideration of which the corporation agreed to pay Vincent 5c per ton of the coal loaded over the tipple. The corporation obligated

itself to operate the tipple and to keep it and the sidetrack in good working condition.

The agreement, however, provided that Vincent was to continue to operate in his own name the Lambert Run strip mines and was to be regarded as the operator of the coal, subject only to the contract of April 26, 1947 between him and Swaney, Inc. for the stripping of the coal. The contract between Vincent and the Weaver Company for the sale of the coal was not assigned to Vincent, Inc.; and Vincent was to continue to receive payment from his sales agents for all the coal loaded over his tipple and sidetrack and was to pay out of the proceeds of the sales brokerage, royalties for the coal, surface rights, rights of way, rental on the sidetrack and buildings and other similar royalties. After deducting all these payments Vincent was to pay the net proceeds of the sales to the corporation. Out of such net proceeds the corporation was to pay Swaney, Inc. the amounts payable for stripping the coal. The contract between Vincent and the corporation was cancellable by either party on 30 days notice.

Between June 30 and December 31, 1947, Vincent turned over to Vincent, Inc., $808,064.46 as the net proceeds from the sale of the coal under the contract and the corporation paid Swaney Contracting Company and Swaney & Sons, Inc. $448,379.25 and also paid other expenses in the aggregate sum of $117,364.42. The result was that the corporation, without having any responsibility

for the mining or the sale of the coal made a handsome profit, merely for the operation of the tipple and subsidiary services.

The Commissioner held that the $808,064.46 which Vincent turned over to the corporation during 1947 was his income and as such was taxable to him and allowed him an additional deduction in the sum of $565,743.67 actually paid out for expenses by Vincent, Inc. during the year 1947. The Tax Court sustained this holding and Vincent has appealed.

In order to complete the recital of the relationship between Vincent and the corporation it should be added that on December 1, 1947, Vincent notified the corporation of his election to terminate the agreement as of January 1, 1948. At or about the same time, however, Vincent was given to understand that the lessor would offer no objection to the assignment of the lease by Vincent to the corporation. Thereupon by agreement of January 2, 1948 Vincent assigned to the corporation his leases on the Lambert Run properties, subject to the strip mining contract between Vincent and Swaney & Sons, Inc. of April 26, 1947. After the assignment the proceeds from the sale of the coal were paid directly to Vincent, Inc. and for the subsequent period during the year 1948 the Commissioner held that the corporation was taxable with the net income derived from the sale of the coal, and this determination is not challenged on this appeal.

Vincent, Inc. was liquidated on January 3, 1949 and Vincent reported a capital gain of $82,644.02 as realized on the liquidation of his stock in the corporation.

We are in accord with the conclusion of the Tax Court that Gregory Run was not justified in deducting the reserves which it set up on its books on the accrual basis for the estimated cost of backfilling the land in 1945 and 1946 at the cost of 10c per ton of coal mined. The situation now before us is distinguishable from that which existed in *Harrold* v. *Comm'r,* 4 Cir., 192 F. 2d 1002, where we held that the estimated cost of refilling a strip coal mine was properly accrued and deducted in the tax year, because the obligation to refill had become fixed in that year and the amount was susceptible of a reasonably accurate estimate in that year based on the actual experience of the taxpayer over a long period. In that case we held, p. 1006, "We conclude that when all the facts have occurred which determine that the taxpayer has incurred a liability in the tax year, and neither the fact nor the amount of the liability is contested, and the amount, although not definitely ascertained, is susceptible of estimate with reasonable accuracy in the tax year, deduction thereof from income may be taken by a taxpayer on an accrual basis." See also *Central Cuba Sugar Co.* v. *Comm'r,* 2 Cir., 198 F. 2d 214, 217, 218; *Patsch* v. *Comm'r,* 3 Cir., 208 F. 2d 532.

We reaffirm that decision, but it does not support the taxpayer's contention in the instant case be-

cause the evidence does not indicate that the amounts accrued were arrived at by a reasonably accurate estimate based upon experience. The only testimony on the point was the bare statement of J. E. Vincent that in his opinion a reasonable estimate of the cost of backfilling was 10c a ton. The opinion was not supported by evidence as to the condition of the land to be refilled or as to the relation, if any, between the amount of coal taken out to the amount of the backfill, or as to the probable cost indicated by the past experience of the witness. The case therefore more closely resembles *Patsch* v. *Comm'r, supra,* in which the rule of the *Harrold* case was approved but the accrual was not allowed because it was not calculated in the light of the actual facts and conditions of the particular area but was based on an arbitrary rule of thumb.

In view of the inadequacy of the estimate of the cost of the backfilling it is unnecessary to consider the further contention of the Commissioner that Gregory's obligation in this connection was merely to reimburse Summit Fuel, if and when Summit Fuel complied with its agreement to make the backfill; and that in fact Gregory was never required to reimburse Summit Fuel because in 1947 Coal Service relieved Gregory of the obligation and there is no evidence that the backfilling has actually been done; and no evidence that Gregory Run reported the accrued amounts as taxable income when Coal Service assumed the responsibility for backfilling in 1947.

We also affirm as correct the holding of the Tax Court that the sum of $808,064.46 turned over by Vincent to J. E. Vincent, Inc. between May 1 and December 1, 1947 must be considered income earned by Vincent as the coal operator and therefore taxable to him. We do not base this conclusion on the view that the corporation and Vincent were actually one and the same entity for purposes of taxation but on the evidence which indicates that the sum involved was the product of Vincent's operations and therefore may not be attributed to the corporation. It is clearly established that throughout the period Vincent continued to be the operator of the enterprise. Indeed it was expressly agreed between him and the corporation that he should continue to fill this role. As such he controlled the production of the coal through his stripping contracts with the Swaney corporations, and also the sale of the coal through his contract with the Weaver Company, his sales agent. These were the productive and essential factors of the business; and there remained only the operation of the tipple, a necessary but nevertheless routine processing step in the production of the coal, involving a relatively stable expenditure and having little influence on the success or failure of the business. There was no dealing at arms' length between Vincent and the corporation as to the compensation to be paid to it for assuming this function; and the turning over of all the profits of the enterprise, reserving to Vincent only 5c per ton for the use of his tipple property, had no genuine

relation to the actual value of the tipple services. This is clearly seen in the income tax return of the corporation for the fiscal year ended April 30, 1948 in which the corporation reported a net income of $322,853.70 and a total income tax liability of $122,684.41.

It is also of importance to note that Vincent had the right to cancel the contract on thirty days notice—and thereby retained such control of the situation as is deemed highly significant in determining the ownership of income. The Tax Court was well justified in concluding that the net result of the arrangement between Vincent and the corporation was that Vincent paid over to it income earned by him as an operator of coal properties and an owner of coal leases and other properties in connection therewith. Under these facts the income must be regarded as Vincent's income and he was not relieved of tax liability thereon. See *Lucas* v. *Earl,* 281 U.S. 111; *Helvering* v. *Clifford,* 309 U.S. 331; *Helvering* v. *Horst,* 311 U.S. 112; *Helvering* v. *Eubank,* 311 U.S. 122; *Harrison* v. *Schaffner,* 312 U.S. 579. *Cf. Blair* v. *Commissioner,* 300 U.S. 5. See also 2 Mertens Law of Federal Income Taxation (1942) § 18.13, n 46a, 1953 Cumulative Pocket Supplement. It is an elementary principle of federal income tax law that an assignment of income, whatever its guise, will not absolve the assignor from income tax liability. *Comm'r* v. *Sunnen,* 333 U.S. 591, 605; *Home Furniture Co.* v. *Com'r,* 4 Cir., 168 F. 2d 312.

Vincent also contends that even if it was incorrect for Vincent, Inc. to report the sum of $808,-064.46 as income during the year 1947, nevertheless a portion of this sum, to wit, the sum of $53,795.64 was in truth and in fact income earned by the corporation. The details underlying this contention are not clearly set forth in the record or in the briefs of the parties and the point is raised for the first time on this appeal. Ordinarily an appellate court does not give consideration to issues not raised below. *Hormel* v. *Helvering*, 312 U.S. 552, 556. We see no reason to depart from this rule under the circumstances in this case, but since our decision will require further proceedings, the Tax Court should consider this contention on remand.

We come then to the question whether the operators who produced the coal under the contracts and assignments hereinbefore described, that is to say, Summit Fuel and the Swaney companies, were entitled to share in the statutory depletion allowance. As to Summit Fuel, it will be recalled that on June 12, 1945 Vincent assigned certain mining leases and also his agreement with the Weaver Company for the sale of the coal to Gregory Run, in consideration of the sum of $10,000 and the payment by Gregory Run of 40c per ton of the coal mined and marketed; and that contemporaneously Gregory Run entered into an agreement with Summit Fuel, another Vincent Company, in which it was agreed that Gregory and Summit should jointly mine the leased premises

and transport and load the coal, and that Gregory should market the coal and should pay to Summit $1.55 per ton for all the coal mined and transported by it; and that in accordance with this agreement Summit Fuel stripped and hauled the coal and was paid the compensation hereinbefore described.

Quite similar were the arrangements between Vincent and the two Swaney companies with respect to the strip mining of coal covered by other leases on land in West Virginia held by Vincent. The Swaney companies were to strip mine the coal, haul it to the siding and dump it in the cars or the tipple, after which Vincent was to have charge of the tipple and the coal and make sale through his agent. The Swaney companies were to furnish the machinery and equipment and sufficient labor to mine and haul a large tonnage per month, and the production was to be continuous and as uniform as possible. All the restoration and backfilling was to be done at the expense of the Swaney companies. For all these services the producer of the coal was to be paid $2.00 per ton in one instance and $2.18 per ton in the other, but provision was made for adjustment of the compensation in the event of changes in the sales price.

We think that the right of the strippers of the coal in these instances to share in the statutory depletion allowance is established by the decision of the Supreme Court in *Burton-Sutton Oil Co.* v. *Comm'r,* 328 U.S. 25. In that case the Cameron Parish School Board, the owner of oil lands, leased the same to one Sweeny who in turn assigned his

rights to the Gulf Refining Company. The School Board and Sweeny each reserved to itself a royalty measured by the oil produced. The Gulf Refining Company in turn entered into a contract with one Sutton who, without reservation of royalty or interest, transferred the contract to the Burton-Sutton Oil Company, the taxpayer. The result was that the taxpayer was under an obligation to develop the oil land and sell the oil and to pay 50 per centum of the proceeds to the Gulf Refining Company. The court held that the 50% payments made by the taxpayer to Gulf were deductible from the taxpayer's gross income and that the contract could not be construed as a sale but rather an assignment of the right to exploit the property with a reservation in the assignor of an economic interest in the oil. In discussing the question as to what constitutes an economic interest entitling the holder to a depletion allowance the court said: (pp. 32, 33, 34, 35):

> "It seems generally accepted that it is the owner of a capital investment or economic interest in the oil in place who is entitled to the depletion. *Anderson* v. *Helvering,* 310 U.S. 404, 407; *Euleon Jock Gracey,* 5 T.C. 296, 302; *Kirby Petroleum Co.* v. *Commissioner, supra.* (326 U.S. 599) Whether the instrument creating the rights is a lease, a sublease or an assignment has not been deemed significant from the federal tax viewpoint in determining whether or not the taxpayer had

an economic interest in the oil in place. *Palmer* v. *Bender,* 287 U.S. 551, 557, 558. Nor has the title to the oil in place been considered by this Court as decisive of the capital investment of the taxpayer in the oil. Technical title to the property depleted would ordinarily be required for the application of depletion or depreciation. It is not material whether the payment to the assignor is in oil or in cash which is the proceeds of the oil, *Helvering* v. *Twin Bell Syndicate,* 293 U.S. 312, 321, nor that some of the payments were in the form of a bonus for the contract, *Burnet* v. *Harmel,* 287 U.S. 103, 111; *Murphy Oil Co.* v. *Burnet,* 287 U.S. 299, 302. Congress, however, has recognized the peculiar character of the business of extracting natural resources. Leases are a method of exploitation of the land for oil and payments under leases are 'income to the lessor, like payments of rent.' Receipts from oil sales are gross income to the operator and subject to statutory deductions. Since lessors as well as lessees and other transferees of the right to exploit the land for oil may retain for themselves through their control over the exploitation of the land valuable benefits arising from and dependent upon the extraction of the oil, Congress provided as early as the Revenue Act of 1918 for equitable apportionment of the depletion allowance between them to correct what was said to be an existing inequality in the law or its administration.

"In the present case the assignor of the petitioner before assignment had an economic interest in the oil in place through its control over extraction. Under the contract with petitioner, its assignor retained a part of this interest—fifty per cent of net. Like the other holders of such economic interest through royalties, the petitioner looked to the special depletion allowances of § 114 (b)(3) to return whatever capital investment it had. The cost of that investment to the beneficiary of the depletion under § 114 (b)(3) is unimportant. Depletion depends only upon production. It is the lessor's lessee's or transferee's 'possibility of profit' from the use of his rights over production, 'dependent solely upon the extraction and sale of the oil,' which marks an economic interest in the oil. See *Kirby Petroleum Co.* v. *Commissioner, supra,* page 604. Through retention of certain rights to payments from oil or its proceeds in himself, each of these assignors of partial exploitation rights in oil lands has maintained a capital investment or economic interest in the oil or its proceeds. As the oil is extracted and sold, that economic interest in the oil in place is reduced and the holder or owner of the interest is entitled to his equitable proportion of the depletion as rent or royalty. The operator, of course, may deduct such payments from the gross receipts."

We see no material difference between the right of the producer of the oil in the cited case to a depletion allowance and the right of the miners of the coal in the instant case to such an allowance. The fact that in the cited case the amount of the compensation of the producer was a specified percentage of the proceeds of the product, whereas in the pending case the compensation of the producer was fixed by the selling price of the coal, adjustable to changes in the market, is not significant; nor is it of importance that in the one case the producer also sold the product whereas in the other the sale of the coal was in the hands of the assignor of the contract. In both cases the depletion was dependent upon production and in both the possibility of profit from the use by the operator of his rights over production was dependent solely upon the extraction and sale of the product and gave him an economic interest therein. As was well said by Judge Watkins in *Eastern Coal Corp* v. *Yoke,* D. C. N. D. W. Va., 67 F. Supp 166, "Irrespective of conveyancing formalties, one who has a right to share in coal produced, also has a corresponding interest in the coal in place." See also *Spaulding* v. *United States,* D. C. S. D. Calif. 17 F. Supp. 957.

As will appear from the cases cited in the *Burton-Sutton Oil Co.* v. *Comm'r* case, it is not always easy to draw the line between a transaction which amounts to a complete sale of the interest of an owner in oil or coal lands and a retention of an

economic interest which entitles the owner to an equitable share of the deduction for depletion. Nor is it always easy to draw the line between transactions which constitute one a purchaser of an economic interest, as distinguished from one who merely performs the labor of production for a fixed sum and thereby becomes merely the hireling of the producer for a specific purpose. We think, however, that in the pending case the rights of the producers were completely dependent upon the extraction of the salable product and that consequently they were entitled to share in the benefits of the statute which were designed to give compensation to persons interested in the production of a wasting asset.

The orders of the Tax Court in these cases are vacated, and the cases are remanded for further proceedings in accordance with this opinion.

JUDGMENT

Filed and Entered April 9, 1954

UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

No. 6767

B. H. SWANEY & SONS, INC., AND SWANEY CONTRACTING COMPANY, PETITIONERS

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITIONS to Review the Decisions of the Tax Court of the United States.

THIS CAUSE came on to be heard on the transcript of the record from the Tax Court of the United States, and was argued by counsel.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the decisions of the said The Tax Court of the United States, in this cause, be, and the same are hereby, vacated; and that this cause be, and the same is hereby, remanded to The Tax Court of the United States for further proceedings in accordance with the opinion of the Court filed herein.

April 9, 1954.

MORRIS A. SOPER,
United States Circuit Judge.

May 10, 1954, mandate issued and transmitted to The Tax Court of the United States in due form.

SUPREME COURT OF THE UNITED STATES

No. — , October Term, 1954

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

B. H. SWANEY & SONS INC. AND SWANEY CONTRACTING COMPANY

ORDER EXTENDING TIME TO FILE PETITION FOR WRIT OF CERTIORARI

UPON CONSIDERATION of the application of counsel for petitioner(s),

IT IS ORDERED that the time for filing petition for writ of certiorari in the above-entitled cause be, and the same is hereby, extended to and including August 7th, 1954.

(S.) HAROLD H. BURTON,
Associate Justice of the Supreme Court of the United States.

Dated this 7th day of July, 1954.

☆ U. S. GOVERNMENT PRINTING OFFICE: 1954 907406 87

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In the Supreme Court of the United States

OCTOBER TERM, 1954

No. 259

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

B. H. SWANEY & SONS, INC., AND, SWANEY CONTRACTING COMPANY, RESPONDENTS

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENTS IN OPPOSITION

The respondents pray that certiorari be denied to the judgment of the United States Circuit Court of Appeals for the Fourth Circuit, entered on April 9, 1954, at least insofar as said Court determined that these respondents, B. H. Swaney, Inc., and Swaney Contracting Company, are entitled to allowances for percentage depletion computed on their respective gross incomes received for the strip-mining production of coal under their respective agreements with J. E. Vincent.

The opinion of the Court of Appeals (212 F. 2d 52) dealt not only with the case involving the Swaney companies, now conditionally sought to be reviewed on the

present petition of the Commissioner of Internal Revenue, but as well with the cases now involved in No. 194, October Term, 1954, in which a petition for certiorari has been filed by—

Gregory Run Coal Company,
J. E. Vincent, and
J. E. Vincent Company, Inc.

The Court of Appeals held that the Swaney companies are entitled to percentage depletion allowances computed on their respective gross incomes from the mining and production of coal and, as a necessary consequence, that J. E. Vincent is not entitled to such an allowance computed on the incomes of the Swaney companies.

The Commissioner has consistently contended that the Swaney companies are entitled to the allowances claimed by them, and now takes the position that the decision of the Court of Appeals is correct, that certiorari should not be granted in No. 194 or in this case, but that, in order to protect the revenues, if certiorari should be granted in No. 194 on the issue of the right of the Swaney companies to depletion, it should also be granted in this case.

As the conditional petition in this case by the Commissioner takes the position that the decision below is correct, there is nothing in that petition to which reply should be made.

The granting of the writ therefore depends upon the petition in No. 194, and to that petition this brief is directed.

The petition in No. 194 goes to two issues with which the Swaney companies are not concerned: whether Summit Fuel Company is entitled to an allowance for percentage

depletion; and whether certain income is taxable to J. E. Vincent or to J. E. Vincent Company, Inc.

This brief is devoted to one proposition, the right of the Swaney companies to percentage depletion allowances upon the record made in their proceedings in the Tax Court of the United States.

QUESTION PRESENTED

Whether the taxpayers, the respondents, are entitled to percentage depletion allowances under Section 23(m) and 114(b) of the Internal Revenue Code, computed on their respective gross incomes received from the mining and production of coal by them under their respective agreements with J. E. Vincent.

The converse is the question on the depletion issue in No. 194:

Whether J. E. Vincent (or J. E. Vincent Company, Inc. depending upon the decision on another issue) is entitled to such percentage depletion allowances computed upon the shares of the Swaney companies in the proceeds of the coal mined and produced by the Swaney companies. In other words, whether in computing his depletion allowance Vincent must deduct or exclude the shares of the Swaney companies.

MISLEADING IMPLICATIONS IN THE QUESTIONS PRESENTED AS STATED IN THE PETITION IN NO. *194*.

The first two questions are misleading in these respects:

1. The term "coal miner" is applied to the Swaney companies, corporations who contracted to mine the coal, assumed the entire burden of exploitation, had exclusive possession of the premises, devoted to the work their entire assets of over $540,000, built miles of roads, furnished the

machinery, equipment, repair shops and skilled employees, assumed sole responsibility for the operations to the relief of Vincent, and during the taxable years in question spent over $495,000 in mining and producing more than 350,000 tons of coal.

The inference is that the issue relates to the individual "coal miner," an employee with no investment and no responsibility. The use of the masculine pronoun "he" contributes to the misleading effect.

2. Coupled with the misleading use of the term "coal miner," is the equally misleading term "compensation", which, in connection with "coal miner" and the masculine singular pronoun, creates the impression of reference to the wages of an individual employee.

STATEMENT

During their respective fiscal years in question B. H. Swaney & Sons, Inc., and Swaney Contracting Company engaged separately in the mining and production of coal by the strip mining method on Lambert's Run in Harrison County, West Virginia, under separate agreements with J. E. Vincent, one of the petitioners in No. 194.

The coal owner, Commercial Coal & Coke Company, had previously leased a large area to Dawson Coal Company and Dawson subleased over six miles of the outcrop coal to Vincent for stripping purposes.

Under his sublease from Dawson, Vincent was obligated:

> To mine all of the coal that could reasonably and practically be mined by strip mining;
>
> To furnish sufficient machinery, equipment and employees to produce 25,000 tons a month;

To mine the coal in accordance with the most approved and modern methods of strip mining, so as to obtain the maximum amount of coal;

To secure the necessary surface stripping rights;

To comply with all laws and regulations and to secure the State stripping permits;

To pursue mining operations with diligence and dispatch; and,

To indemnify Dawson against all claims, etc.

Vincent complied with these and the other requirements of his sublease by obligating the Swaney companies, each as to the area assigned to it, to fulfill all Vincent's obligations under the Dawson-Vincent lease, except that Vincent retained and performed three functions: the securing of surface rights and reservation leases; the operation of the tipple; and the payment of royalties under his leases.

The two Swaney contracts included the whole area of the Dawson-Vincent sublease and the Swaney companies had exclusive possession thereof.

By their separate agreements, the Contracting Company contract of December 24, 1945, and the Swaney & Sons contract of April 26, 1947, Vincent obligated the Swaney companies to:

Furnish adequate equipment, materials and labor to mine 25,000 tons a month;

Comply with the West Virginia strip mining law by giving bonds (the bonds totalled $30,000) and securing permits;

Build roads for access to the coal (over four miles of main road were built, with numerous access roads leading to the stripping areas);

Comply with all the requirements of the surface and

reservation leases, as to backfilling, building roads and fences, etc.;

Move and protect gas pipe lines, telephone and electric lines, highways, etc.;

Save Vincent harmless from their operations, and carry public liability and property damage insurance as further protection to Vincent; and,

In all respects operate as independent contractors.

Each contract further provided:

> "Said second party shall strip mine and remove said coal, * * * and in all other respects * * * shall comply with * * * said coal lease * * * in the same manner as said first party (Vincent) would be obliged to comply * * * *if he were himself operating and producing coal under said lease.*" (Emphasis added.)

Both the Tax Court and the Court of Appeals found that the Swaney companies complied with all these requirements.

The agreements were not cancellable except on specified defaults or in the event the coal price fell below specified points, short of which price decreases would be shared pro rata.

Under these agreements, the Swaney companies were entitled to and did receive shares determined on monthly averages of the sales prices of the coal mined by them, after the sales agent's commission, as follows:

> Contracting Company received $2.00 of the first $2.88 a ton, plus ¾ of the excess of the net sales price over $2.88; and, over the producing period of its contract, its share per ton varied from $2.00 to $3.14 with net sales prices from $2.88 to $5.28.

Swaney & Sons received $2.18 of the first $3.25 a ton, plus ½ of the excess of the net sales price over $3.25; and, over the producing period of its contract, its share per ton varied from $2.18 to $3.145 with net sales prices from $3.25 to $5.28.

There is nothing in either contract calling for any other payment to the Swaney companies, and they were not entitled to, and did not receive, any payment except for coal mined by them. Immediately upon receipt from Weaver (the sales agent or broker) of its check and monthly report for the coal mined by the Swaney companies during the preceding month, Vincent computed and gave the Swaney companies their respective reports and checks.

The Swaney companies were wholly engaged in this enterprise and by the ends of their fiscal years in question had devoted to it assets with a value of over $540,000. They produced during these fiscal years over 350,000 tons of coal at a cost to them of more than $495,000.

No coal was mined except on specific orders for particular sizes from the customers to whom it had been sold by Weaver. The volume of production was severely limited by the inadequate railroad car supply.

ERRORS OR OMISSIONS IN THE STATEMENT OF THE CASE IN THE PETITION IN NO. *194*.

Page 5—last paragraph: There are other differences than the compensation, between the Gregory Run-Summit contract and the Vincent-Swaney contracts:

(1) The Summit contract could be cancelled on thirty-day notice while the Swaney contracts could not be cancelled except for specified cause or if the price of coal fell below specified points;

(2) Gregory Run furnished all the machinery and equipment used by Summit, while the Swaney com-

panies were required to, and did, furnish all their own machinery and equipment, which is an important difference in the capital investment in exploitation, a factor basic to economic interest; and,

(3) Gregory Run posted the statutory bond and secured the West Virginia State stripping permit for Summit's operations, Gregory Run thus being recognized by the State as the miner and producer of the coal under the permit, just as the Swaney companies, by giving bonds totalling $30,000 and securing the permits for their operations, were recognized by the State as the miners and producers of their coal.

Page 6—line 4: The statement that the Swaney companies were to be paid for each ton of coal sold by Vincent. The contracts provided that the Swaney companies were to be paid "for all merchantable strip coal strip mined by said second party on the above described premises and hauled to and loaded or dumped at said tipple or tipples."

Page 11: The alleged letter from the National Coal Association is not a part of the record in the Swaney proceedings. From its date it is safe to assume that it is not a part of the record in No. 194.

"* * * Congress was free to give such an arbitrary allowance as the deduction was an act of grace. *In answer to the contention that the provision may produce 'unjust and unequal results',* we have remarked that this is likely to be so 'wherever a rule of thumb is applied without a detailed examination of the facts affecting each taxpayer.' * * *

"The rule being of this sort for obvious reasons of administrative convenience, we must apply it in the simple manner it contemplates." (Emphasis added.) *Helvering* v. *Mountain Producers Corporation,* 303 U. S. 376, 381, 382.

ARGUMENT

1. *The Concept of Economic Interest.*

To be entitled to a percentage depletion allowance a taxpayer must have what is called an economic or capital interest. Sometimes reference is made to the necessity of a capital investment.

When used in relation to depletion allowances these terms have peculiar meanings. They are not then used in the usual accounting concept of something acquired for a consideration which can be stated on a balance sheet in terms of dollars.

These meanings are best explained in General Counsel Memorandum 22730, Cum. Bul. 1941-1, 214. Referring to *Palmer* v. *Bender*, 287 U. S. 551, the Chief Counsel of the Bureau of Internal Revenue said, at page 216:

> "Such language indicates that the Court regarded the contracts between the interested parties as dividing the property rights in oil and gas in place in accordance with their respective shares upon production. That is, the lessor, by lease terms reserving royalties, merely grants to the lessee exclusive exploitation privileges, retaining as his share of the oil and gas in place that portion thereof which, freed of the burdens of development and operating costs, has a value equivalent to the value of the entire interest subject to such burdens, and, therefore, like the lessor of an ordinary lease reserving rent, is regarded as not having disposed of a capital asset. The remaining fractional interest in oil and gas in place becomes the share of the lessee's working or operating interest which carries the risks and burdens attending exploitation. *If the lessee in turn subleases or assigns* the working interest, reserv-

> ing a royalty share, he acquires a status comparable to that of a lessor with respect to the share retained, any further burden of exploitation being passed on to the sublessee or assignee with an agreed share in the oil and gas produced. So considered, the view that a lessor, or a sublessor or assignor, parts with no capital interest, *though the lessee, or sublessee or assignee, acquires a capital interest upon the execution or assignment of a lease,* presents no logical difficulties, as the lessee interest, though it may have great potential value, ordinarily becomes valuable only upon investment by the lessee in exploitation or by reason of discovery. * * * The lessor does not sell an interest to the lessee. Instead, *the lessee acquires an interest by assuming the obligation to develop and operate the property.*" (Emphasis added.)

Thus, upon the execution of their contracts with Vincent, there arose in the Swaney companies economic or capital interests because of their assumption of the burden of exploitation, the obligation to develop and produce the coal. This gave the Swaney companies a valuable right in the coal in place, a right diminishing as the coal was extracted.

The consideration which passed from the Swaney companies was their assumption of the obligation to develop and produce.

The investment of the contractors was not in the purchase of their economic interests, but in the equipment with which to develop and operate, the capital investments necessary to production. See, at page 220 of said memorandum, the discussion of *Helvering* v. *Bankline Oil Co.*, 303 U. S. 362, and *Helvering* v. *Mountain Producers Corp.*, 303 U. S. 376. The Chief Counsel said that in *Bankline*—

"* * * the taxpayer's capital investment was in equipment facilitating delivery of the gas produced rather than in equipment for production of gas, and that its function was not production of gas but the processing of gas. The Mountain Producers case, supra, is distinguishable in that the refining company purchaser therein was a producer and was required to make the capital investments necessary to production that gave the producer an economic interest in oil and gas in place."

To digress, it could as well be said here that Vincent's active part in the instant case was that of a processor after production. On this theory he would be entitled to depletion not because of his operation of the tipple and the marketing of the coal, but because he was an assignor receiving the equivalent of a royalty. In the words of the memorandum (at page 216), Vincent acquired a status comparable to that of a lessor with respect to the share retained by him, his burden of exploitation having been passed on to the Swaney companies.

It is important to note in said memorandum the emphasis upon the burden of exploitation being passed on by the contracts between the parties.

As will appear from a reading of the whole memorandum, all these ideas have been much more fully developed in relation to oil and gas, where the percentage depletion rate is 27½%, than they have been in relation to coal, with a rate of 5% (10% since the Revenue Act of 1951). In the many oil and gas cases the courts have recognized divisions of the burden of exploitation much more varied than are found in the coal fields. The case considered in said memorandum involved six parties, with differing contractual rights. The memorandum states that all but one

of the six were entitled to depletion, that one having contracted away his depletable right for a net profit return (which would probably qualify now under *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U. S. 25, and *Kirby Petroleum Co.*, v. *Commissioner*, 326 U. S. 599, both decided in 1946, five years after the issuance of the memorandum, and sustaining percentage depletion allowances to parties entitled only to share in net profits).

Saying that it is immaterial whether the return to the taxpayer is in the form of a fraction of the mineral product, or the proceeds therefrom, or a stated sum per unit of production, the memorandum continues, at page 218:

> "Aside from such bonus payment to a lessor or assignor, the term 'gross income,' as used in the phrase 'gross income from the property' in the percentage depletion provisions, means the same as 'gross income' in the provisions generally defining income, with the qualification that the phrase 'gross income from the property' in the depletion provisions is confined to the gross income from the extraction of oil rather than gross income from the tract of land in all its uses."

It thus appears that so long as it constituted "gross income from the property" in the hands of the Swaney companies, it is immaterial whether their gross incomes passed to them in any specified manner, or were computed in any particular way. The only requirement is that they derived them by reason of their production of coal.

The emphasis is upon the *extraction* and income therefrom. It is said in Kenneth G. Miller's Oil and Gas Federal Income Taxation (2nd ed., 1951), at page 15, that perhaps the best general definition of the phrase "economic inter-

est" is found in the statement of said memorandum at page 220:

> "*Assurance of a share upon production* marks ownership of an economic interest in oil and gas in place. Division of production income and the attending depletion allowances between owners of economic interests necessarily exclude all others." (Emphasis added.)

The basis for the depletion allowance is production. And it is the assurance of *a* share *upon production* which entitles the Swaney companies to depletion.

> "* * * only a taxpayer with an economic interest in the asset, here the oil, is entitled to the depletion. * * * By this is meant only that under his contract *he must look to the oil in place as the source* of the return of his capital investment. The technical title to the oil in place is not important." (Emphasis added.)
>
> *Kirby Petroleum Co.* v. *Commissioner, supra,* at page 603.

> "The term 'gross income from the property' means gross income from the oil and gas * * * and the term should be taken in its natural sense. With the motives which lead the taxpayer to be satisfied with the proceeds he receives we are not concerned. * * * Nor, when oil or gas is produced, does the statute base the percentage on the market value. The gross income from to time may be more or less than market value according to the bearing of particular contracts."
>
> *Helvering* v. *Mountain Producers Corp., supra,* at 382.

In this view it is immaterial whether Vincent sold the coal or the Swaney companies sold the coal, whether Vin-

cent received the proceeds and divided with the Swaney companies or they received the proceeds and divided with him, or whether Weaver (the sales agent or broker) sent each his own share, or whether the Swaney companies received their agreed share from Vincent because he contracted to pay them for every ton mined. In each of these events the Swaney companies were assured of and did receive *a* share *upon production*. If they produced coal, they were to be, and were, paid. It is not required that the share be of any particular type or be calculated or paid by any particular method, but merely that it be *a* share and that the contractor be assured of receiving it for each unit of mineral he produces.

The Swaney companies were to be paid only for coal mined. There is no hint in the contracts, or in the conduct of the parties, of any other payment to them. Their right to depletion is clear.

In General Counsel Memorandum 26290, Cum. Bul. 1950-1, 42, the Chief Counsel expressed the opinion:

> "* * * that, dependent upon their rights in respect of the properties involved, stripping contractors may be properly regarded as entitled to the deduction for depletion in all respects as in the case of other mineral properties. The fact that some of the contracts bear aspects of agency or employment, or that ostensibly the contractor may not acquire legal title to the mineral, does not control."

II. *Differences in Origin of the Rights of the Parties.*

Because each decision deals only with its own facts and issues, it is sometimes difficult to keep in mind the essential differences between the rights of the various parties in the various cases. For example, and without attempting to be exhaustive, there are—

(a) The right of the lessor, sublessor or assignor (such as Vincent in the instant case) which stands on his having *retained* an economic interest when he passed on the burden of exploitation.

Thomas v. *Perkins*, 301 U. S. 655, and *Anderson* v. *Helvering*, 310 U. S. 404, deal with this right. In *Perkins* the assignors qualified, but in *Anderson* the assignor did not, because its money was not payable from production only.

It is in cases of this type that *ownership* is a factor. Here the lessor, sublessor or assignor must have owned an interest in the mineral prior to making his lease, sublease or assignment. That interest need not be a legal title, and it may consist of a lessee's or assignee's working or operating interest. Without such an interest he would be a "stranger to the lease", as was O'Donnell in *Helvering* v. *O'Donnell*, 303 U. S. 370. Without such an interest, there is nothing of which he can *retain* a part, to qualify what he receives as a depletable share of the proceeds of production. This is so because he has no part in the actual production. Those within (b) below participate in one way or another in the production, and the producer, of course, is the one who bears the remaining burden of exploitation, the one who accomplishes the Congressional purpose of extraction of the mineral.

(b) The right of the equipment dealer or investor who furnishes equipment or money which the operator is pledged to use in developing the property and who receives therefor a royalty or an oil payment. A royalty runs for the life of the property, while an oil payment has a maximum limit, usually in dollars. The essential factor qualifying both is that they are payable from production only.

Several types of this sort of right are discussed in G.C.M. 22730, *supra*.

(c) The right of the producer (such as the Swaney companies) who has an economic interest by reason of his assumption and fulfillment of the burden of exploitation.

The right of the producer to depletion on his own share of the proceeds of his production has been seldom questioned. The issue is usually whether the share of some one else also qualifies, as in *Palmer* v. *Bender, Perkins, O'Donnell, Bankline, Mountain Producers, Anderson, Kirby,* and *Burton-Sutton,* all *supra.*

Among the few cases, where the producer's own share was in issue, is *Spalding* v. *Commissioner,* 35 B.T.A. 132 (appeal dismissed 100 F. 2d 1020), where in sustaining the producer's right the Board said, at page 138:

> "Here the Oil Co. by the terms of the agreement relieved the petitioner of all risks and burdens connected with the development and operation of the lease."

The same facts, for different years, were involved in *Spalding* v. *United States,* 97 F. 2d 697 (CCA-9; affirming 17 F. Supp. 957; cert. den. November 7, 1938, 305 U. S. 644; motion to recall denial of cert. denied November 21, 1938, 305 U. S. 571; rehearing denied December 5, 1938, 305 U. S. 644). The District Court had said, at page 965, that the Oil Company which "assumes the entire burden of operation and production imposed upon the lessee * * * and which, in the exploitation of the property incurs expenditures running into hundreds of thousands of dollars and assumes sole responsibility toward all who participate in the exploitation, cannot be said to be merely a 'hired man' or to be 'merely working for hire.' It has the 'economic interest in the oil, in place'" required by *Palmer* v. *Bender.* And, in affirming, the Court of Appeals said, at page 700;

> "Though referred to in the agreement as a 'contractor', the Oil Company was not, as contended by appellant, a mere contractor for hire. It had the right to, and did, occupy the leased property and produce oil and gas therefrom."

As noted above, this Court refused three times to review the *Spalding* case.

In *North Range Mining Company*, 46 B.T.A. 296 (Acq., Cum Bul. 1942-1, 13), Ford, the sublessee of an ore mine, contracted with North Range to operate and deliver certain quantities to Ford for $1.25 a ton. Note that there was no sale, as North Range produced Ford's ore for Ford's use. The Board said, in sustaining the right of the producer to depletion, at page 301:

> "* * * the practical result, as petitioner suggests in its brief, was the same as if the ore had been sold to Ford at market and petitioner had paid royalties to Ford approximating the difference between the market price and the contract price. In that case Ford would have been entitled to depletion deductions on the royalty interest which it retained and petitioner would have been entitled to depletion deductions on the amounts received from Ford."

Eastern Coal Corp. v. *Yoke*, 67 F. Supp. 166 (D.C., N. D. W. Va., 1946), was very similar to *North Range*. Eastern contracted with Ford to operate and deliver certain quantities of coal to Ford for $1.46 a ton. Here also there was no sale, as Eastern produced Ford's coal for Ford's use. The District Judge said, at page 177:

> "Counsel have not cited and I have not found a single case among the many cases involving percentage depletion where the actual producer has been denied

percentage depletion with respect to his interest in the proceeds of the mineral produced."

III. *The Asserted Conflict Does Not Exist.*

The petition for the writ in No. 194 stands on the assertion that the decision of the Court of Appeals is in conflict with the principles of three decisions of this Court:

1. In *Thomas* v. *Perkins, supra*, Hammonds and Branson, owners of leases, that is, lessees, assigned them to Perkins for cash and notes and $395,000 to be paid them out of the oil produced. The question was whether the operator, Perkins, should include in his gross income the payments made by the purchasers of the oil directly to Hammonds and Branson on account of the $395,000.

This Court held that Hammonds and Branson retained an interest in the deposit and as they "would be entitled to an allowance for depletion in respect of the oil sold out of their share, the income from that interest is not chargeable to" Perkins, the producer.

2. In *Helvering* v. *O'Donnell, supra*, O'Donnell owned stock in the San Gabriel Company and sold it to the Midway Company, which agreed to pay him one-third of the net profits from the San Gabriel oil and gas properties which Midway agreed to acquire. O'Donnell claimed depletion on his one-third, but this Court disposed of his claim on the obvious ground that he was "a mere owner of shares" and had no interest in the oil and gas in place either before or after his sale of stock. In the words of *Kirby*, he "was a stranger to the lease."

3. In *Anderson* v. *Helvering, supra*, the Oklahoma Company sold land and mineral interests to Pritchard for $160,000, of which $110,000 was to be paid from one-half of

the proceeds of the oil and gas produced *and* from the sale of any or all of the land. The question was whether the Oklahoma Company's one-half of the oil proceeds should be included in the gross income of Pritchard, the operator.

This Court held that as the one-half was not payable solely out of production, it was not an oil payment within the rule of *Perkins*, which, it said, is to be confined to the "situation in which, as a matter of substance, without regard to formalities of conveyancing, the reserved payments are to be derived solely from the production of oil and gas." Not being confined to payment out of production, these payments were purchase money and not deductible or excludable from the taxable gross income of Pritchard.

The Principles of These Three Decisions

As this Court pointed out in *Anderson*, the distinguishing feature of *Perkins* is the reservation by the assignor of an interest in the mineral, such a reserved interest being an economic interest supporting depletion.

O'Donnell stands for the proposition that to have an economic interest one must have some closer connection to mineral in place than that of a stockholder in a corporation owning the mineral. It is obviously not in point.

Anderson and *Perkins* hold that the producer may not deduct (or exclude) from his taxable income the share of the proceeds of production going to his assignor unless the assignor has an economic interest, in which event the assignor is entitled to depletion on his share and must include it in his taxable income.

Certainly there is nothing in these cases in conflict with the holding here of the Court of Appeals, which saw clearly that the Swaney companies had assumed the burden of

exploitation and had mined and produced the coal, and that under the contracts the proceeds of production were divided between Vincent, the sublessee and assignor, and the Swaney companies, the producers. The Court accordingly held that each was entitled to depletion upon his contractual share of the proceeds and denied to Vincent the right to take depletion upon the shares of the Swaney companies.

The decision of the Court of Appeals on the present issue may be summarized in these words from page 663 of the *Perkins* opinion (inserting the names of the present parties):

> "* * * The owner (Vincent) of an interest in the deposit is entitled to deduct for depletion of the part producing his income but may not deduct for depletion of a share belonging to another (the Swaney companies)."

These cases support the right of Vincent, an assignor with a reserved economic interest, to deduct depletion on his contractual share of the proceeds of the coal mined and produced by the Swaney companies. But that is not in controversy here.

What *is* in issue here is the claim of Vincent to depletion computed upon the shares of the Swaney companies in the proceeds of their own production. As illustrated by the quotation above from *Perkins,* Vincent's claim gains no support from either *Perkins* or *Anderson,* both of which hold that a party may take depletion only on his own share of the proceeds.

IV. *The Opinion Below.*

The opinion of the Court of Appeals concludes with this statement:

"We think, however, that in the pending case the rights of the producers were completely dependent upon the extraction of the salable product and that consequently they were entitled to share in the benefits of the statute which were designed to give compensation to persons interested in the production of a wasting asset.'

CONCLUSION

The decision below is correct. The conditional petition here and the petition in No. 194 should be denied.

Respectfully submitted,

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